Adjusting Accounts For Financial Statements

Chapter 3

Wild and Shaw

Fundamental Accounting Principles

25th Edition

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Chapter 3 Learning Objectives

CONCEPTUAL

C1 Explain the importance of periodic reporting and the role of accrual accounting.

ANALYTICAL

A1 Compute and analyze profit margin.

PROCEDURAL

P1 Prepare adjusting entries for deferral of expenses.
P2 Prepare adjusting entries for deferral of revenues.
P3 Prepare adjusting entries for accrued expenses.
P4 Prepare adjusting entries for accrued revenues.
P5 Prepare financial statements from an adjusted trial balance.
P6 *Appendix 3A*—Explain the alternatives in accounting for prepaids.

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Learning Objective C1

Explain the importance of periodic reporting and the role of accrual accounting.

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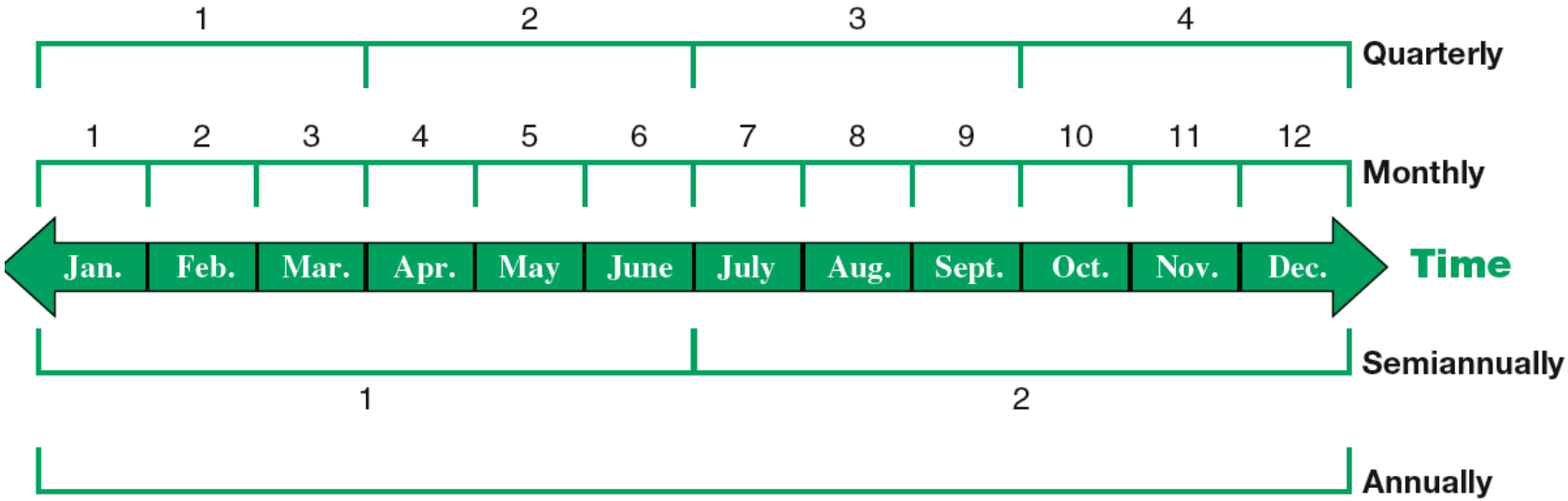
The Accounting Period

Exhibit 3.1



Learning Objective C1: Explain the importance of periodic reporting and the role of accrual accounting.

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Accrual Basis versus Cash Basis

Accrual Basis

Revenues are recorded when products or services are delivered, and records expenses when incurred.

Cash Basis

Revenues are recorded when cash is received and expenses are recorded when cash is paid.

Learning Objective C1: Explain the importance of periodic reporting and the role of accrual accounting.

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Accrual Basis versus Cash Basis
Accrual Basis Example[1]

Exhibit 3.2

Transaction:
Paid $2,400 for 24 months' insurance beginning Dec. 1, 2021
Insurance Expense 2021
Jan $0 Feb $0 Mar $0 Apr $0
May $0 June $0 July $0 Aug $0
Sept $0 Oct $0 Nov $0 Dec $100
2021
Insurance Expense 2022
Jan $100 Feb $100 Mar $100 Apr $100
May $100 June $100 July $100 Aug $100
Sept $100 Oct $100 Nov $100 Dec $100
2022
Insurance Expense 2023
Jan $100 Feb $100 Mar $100 Apr $100
May $100 June $100 July $100 Aug $100
Sept $100 Oct $100 Nov $100 Dec $0
2023

On the accrual basis, $100 of insurance expense is recognized in 2021, $1,200 in 2022, and $1,100 in 2023.

The expense is matched with the periods benefited by the insurance coverage.

Learning Objective C1: Explain the importance of periodic reporting and the role of accrual accounting.

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Accrual Basis versus Cash Basis
Accrual Basis Example 2

Exhibit 3.3

Transaction:
Paid $2,400 for 24 months' insurance beginning Dec. 1, 2021
Insurance Expense 2021
Jan $0 Feb $0 Mar $0 Apr $0
May $0 June $0 July $0 Aug $0
Sept $0 Oct $0 Nov $0 Dec $2,400
2021
Insurance Expense 2022
Jan $0 Feb $0 Mar $0 Apr $0
May $0 June $0 July $0 Aug $0
Sept $0 Oct $0 Nov $0 Dec $0
2022
Insurance Expense 2023
Jan $0 Feb $0 Mar $0 Apr $0
May $0 June $0 July $0 Aug $0
Sept $0 Oct $0 Nov $0 Dec $0
2023

On December 1, 2021, FastForward paid $2,400 cash for a 24 month business insurance policy.

Using the **cash basis**, the entire $2,400 would be recognized as insurance expense in 2021. No insurance expense from this policy would be recognized for the 2022 or 2023 periods covered by the policy.

Learning Objective C1: Explain the importance of periodic reporting and the role of accrual accounting.

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Recognizing Revenues

The **revenue recognition** principle requires that revenue be recorded when the goods or services are provided to customers and at an amount expected to be received from customers.

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Recognizing Expenses

The **expense recognition** (or matching) principle requires that expenses be recorded in the same accounting period as the revenues that are recognized as a result of those expenses. This matching of expenses with the revenue benefits is a major part of the adjusting process.

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Framework for Adjustments

There are four types of adjustments for transactions that extend over more than one period.

Adjustments are made using a 3-step process:

Step 1: Determine what the current account balance *equals*.

Step 2: Determine what the current account balance *should equal*.

Step 3: Record an adjusting entry to get from step 1 to step 2.

Learning Objective C1: Explain the importance of periodic reporting and the role of accrual accounting.

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Learning Objective P1

Prepare adjusting entries for deferral of expenses.

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Prepaid (Deferred) Expenses

Prepaid expenses are assets paid for in advance of receiving their benefits.

Examples: Prepaid Insurance, Prepaid Rent, Supplies

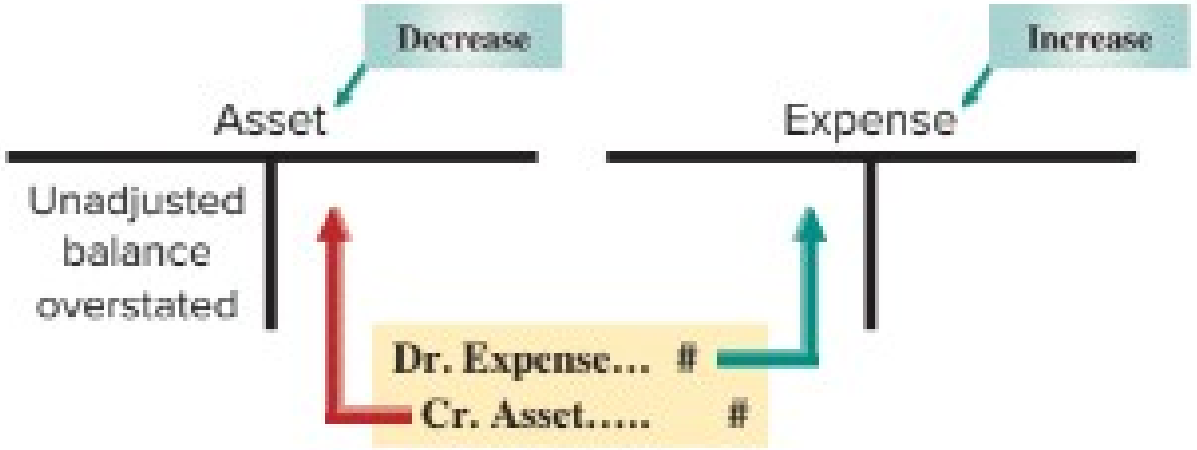

Exhibit 3.5

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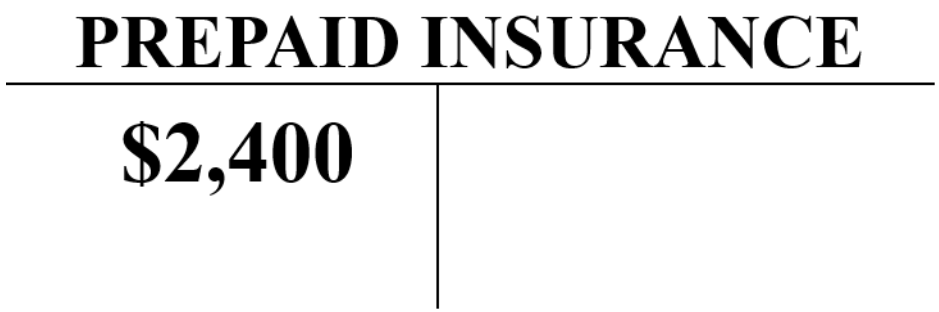
Adjusting for Prepaid Insurance Step 1

Step 1: Determine current balance:

- FastForward paid $2,400 to cover insurance for 24 months that began on December 1, 2021.
- FastForward recorded the expenditure as *Prepaid Insurance* on December 1.

24-month policy Beginning 12/01



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Adjusting for Prepaid Insurance Step 2

Step 2: Balance in prepaid insurance should equal $2,300.On 12/31, $100 for one month's worth of insurance has expired.

PREPAID INSURANCE	
$2,400	$100

INSURANCE EXPENSE	
$100	

$2,400/24 months = $100

Insurance Expense **is debited $100 to recognize the amount of insurance coverage for December and** ***Prepaid Insurance*** **is credited for $100 to reduce it's balance to $2,300.**

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Adjusting for Prepaid Insurance Step 3

(Balance Sheet)

PREPAID INSURANCE

$2,400	**$100 adj.**
Bal. **$2,300**	

(Income Statement)

INSURANCE EXPENSE

adj. $100

The Balance Sheet will show $2,300 (23 months) of Prepaid Insurance remaining!

The Income Statement will show $100 (1 month) of insurance expired!

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Adjusting Entry for Prepaid Insurance

The general journal adjustment on Dec. 31 and general ledger account balances are as follows:

Prepaid Insurance 128

Dec. 1	2,400	Dec. 31	100
Bal.	2,300		

Insurance Expense 637

Dec. 31	100		

Dec. 31 Insurance Expense	100	
Prepaid Insurance		100
To record first month's expired insurance		

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Adjusting for Supplies Steps 1 and 2

Step 1: FastForward purchased $9,720 of supplies in December. Some of these supplies were used during December.

Step 2: A physical count performed on 12/31 shows that unused supplies equal $8,670.

Purchases during December

SUPPLIES

$9,720	

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Adjusting for Supplies Step 3

Step 3: Adjusting entry reduces Supplies by $1,050 or the difference between the beginning balance and the physical count on 12/31.

(Balance Sheet)

SUPPLIES

$9,720	**$1,050 adj.**
Bal. **$8,670**	

(Income Statement)

SUPPLIES EXPENSE

adj. $1,050

The Balance Sheet will show $8,670 of supplies remaining!

The Income Statement will show $1,050 (1 month) of Supplies expired!

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Adjusting Entry – Supplies

We've seen the adjustment in the T-accounts but we need to record the adjustment on Dec. 31 in the *General Journal*

Supplies		126	
Dec.	9,720	Dec. 31	1,050
Bal.	8,670		

Supplies Expense		652	
Dec. 31	1,050		

Dec. 31	**Supplies Expense**	**1,050**	
	Supplies		**1,050**
	To record Supplies used		

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Depreciation

Instead of expensing the cost of a **plant asset** (equipment, building, cars, etc.) in the year it is purchased we allocate, or spread out, the cost over their expected useful lives. This is called depreciation.

The formula for *straight-line* depreciation is:

$$\text{Straight-Line Depreciation} = \frac{\text{Asset Cost} - \text{Salvage Value}}{\text{Useful Life}}$$

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Adjusting for Depreciation – Step 1

- FastForward purchased equipment on Dec. 1 for $26,000.
- It has an estimated useful life of five years.
- The equipment is expected to be worth about $8,000 at the end of five years.
- They purchased the equipment on Dec. 1 but it is now Dec. 31.

Because FastForward expects the equipment to be worth $8,000 when the five years are over, only $18,000 of the cost will be spread over the next 5 years (60 months).

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Straight-Line Depreciation

Step 1: FastForward purchased equipment on December 1 for $26,000.

Calculate *Net Cost* (amount to depreciate).

Original Cost	−	Salvage Value	=	Net Cost
$26,000	−	$8,000	=	$18,000

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Adjusting for Depreciation – Step 2

- Equipment has a useful life of 5 years. The equipment is expected to be worth $8,000 at the end of five years. FastForward is using straight-line depreciation. $18,000 ($26,000 – $8,000) of the cost needs to be spread over the next 60 months.
  One month = $18,000 / 60 = $300.

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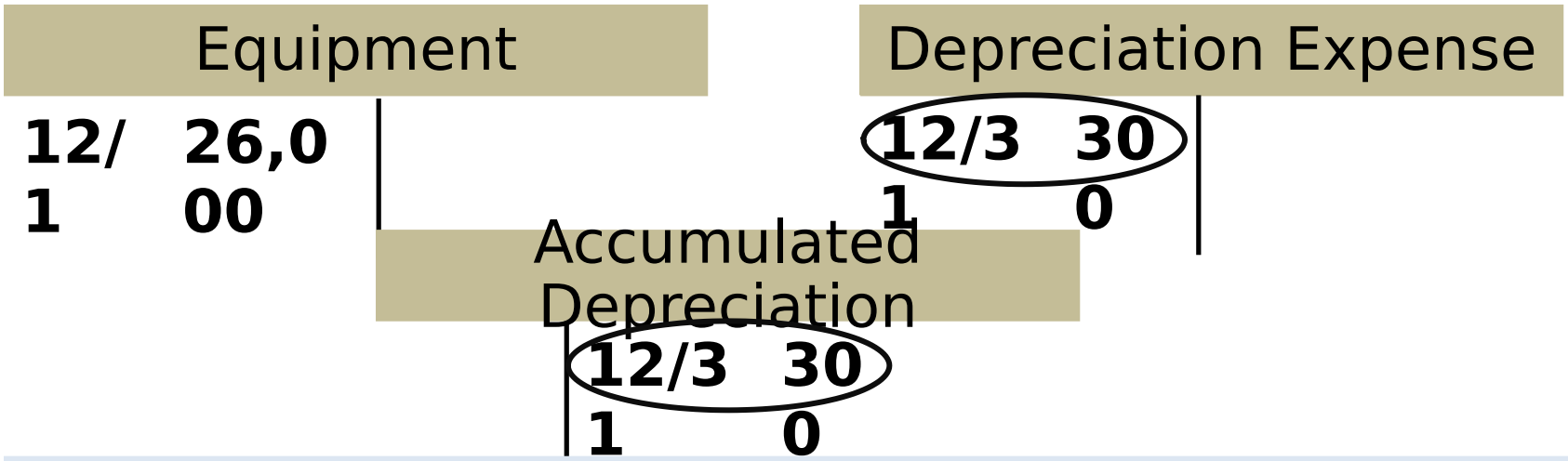
Adjusting for Depreciation – Step 3

Depreciation adjustment reflected in our T-accounts looks like this:



- Record adjusting entry for $300 for one month.
- The depreciation amount of $300 is credited to the **Accumulated Depreciation** account instead of the asset account.

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Adjusting Entry for Depreciation

Equipment	
12/1	26,000

Depreciation Expense	
12/31	300

Accumulated Depreciation-Equipment	
	12/31 300

Dec. 31	Depreciation Expense	300	
	Accumulated Depreciation-Equipment		300
	To record monthly equipment depreciation		

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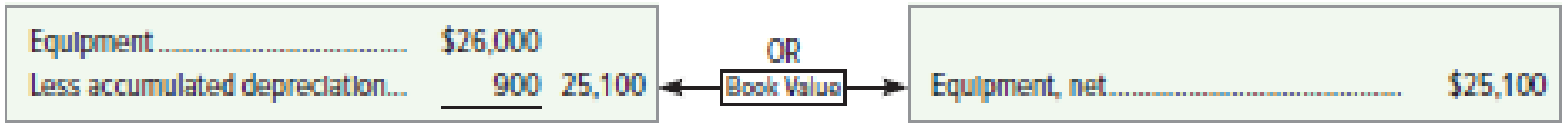
Depreciation – Balance Sheet

On February 28, 2022, after three months of depreciation have been taken, the Equipment is shown at its $25,100 book value, or net of accumulated depreciation.

Exhibit 3.7



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Learning Objective P2

Prepare adjusting entries for deferral of revenues.

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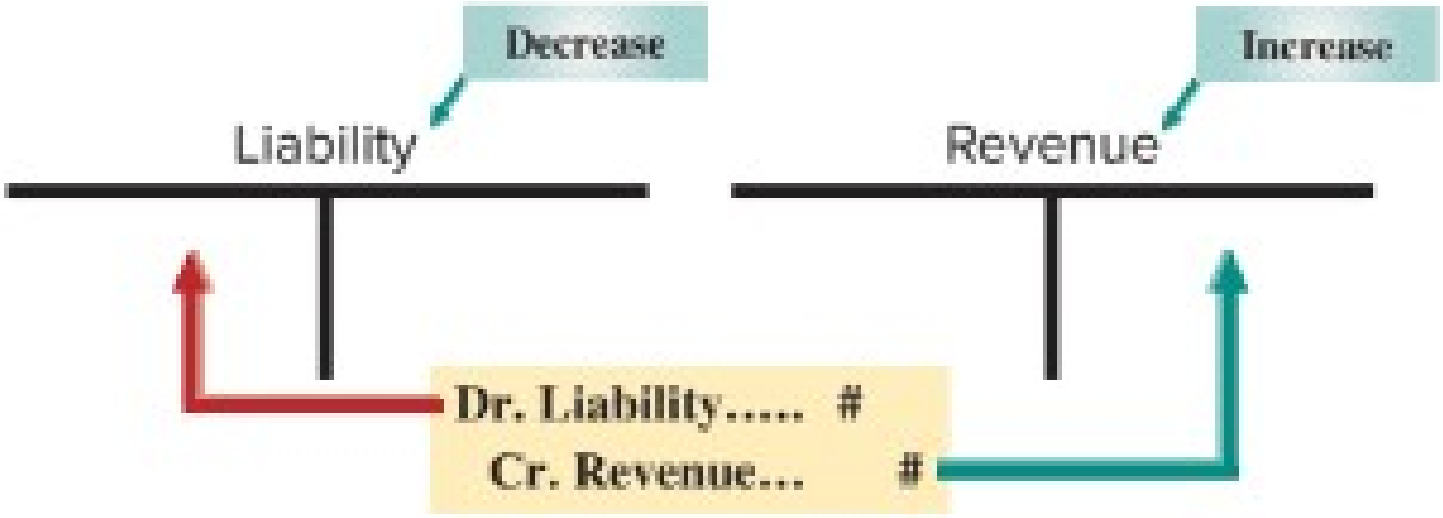
Deferral of Revenue

Unearned revenue is cash received in advance of providing products or services.

Exhibit 3.8



Learning Objective P2: Prepare adjusting entries for deferral of revenues.

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Adjusting for Unearned Revenues – Steps 1 and 2

Step 1: FastForward's client paid a 60-day fee in advance covering the period from 12/27 – 2/24 and recorded:

Dec. 26	Cash	3,000	
	Unearned Consulting Revenue		3,000
	Received advance payment for		

Step 2: FastForward earns payment as time passes. At 2/31, 5 days' service is earned, 5/60 × $3,000 = $250.

Step 3: Adjusting entry reduces liability, Unearned Consulting Revenue, by $250 for 5 days' of revenue. Consulting Revenue of $250 is earned.

Learning Objective P2: Prepare adjusting entries for deferral of revenues.

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Adjusting for Unearned Revenue – Step 3

(Balance Sheet)

UNEARNED CONSULTING REVENUE

12/31 **$250**	**$3,000** 12/26
	$2,750 12/31 Bal.

The Balance Sheet will show $2,750 of Unearned Consulting Revenue unearned.

(Income Statement)

CONSULTING REVENUE

	$5,800
	250 12/31
	$6,050 12/31 Bal.

The Income Statement will show $6,050 total Consulting Revenue earned.

Learning Objective P2: Prepare adjusting entries for deferral of revenues.

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Adjusting Entry for Unearned Revenue

Adjusting entry recorded on Dec. 31 transfers $250 from unearned to earned consulting revenue.

Dec. 31	Unearned Consulting Revenue	250	
	Consulting Revenue		250
	To record earned revenue received in advance		

Learning Objective P3: Prepare adjusting entries for accrued expenses.

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Learning Objective P3

Prepare adjusting entries for accrued expenses.

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Accrued Expense

Accrued expenses are costs incurred in a period that are both unpaid and unrecorded.

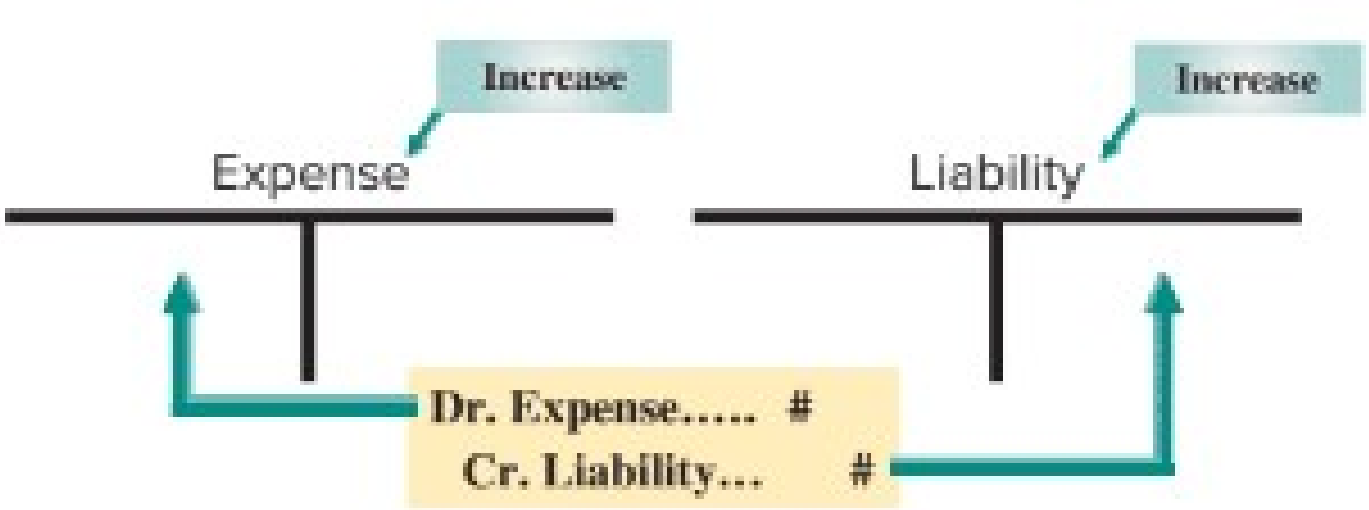

Exhibit 3.9

Learning Objective P3: Prepare adjusting entries for accrued expenses.

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Adjusting for Accrued Salaries – Steps 1, 2, and 3

Step 1: FastForward pays its employee $70 per day, or $350 for a five-day work week. Salaries are paid every two weeks on a Friday.

Step 2: 12/31 is a Wednesday, so three day's salaries are owed at year end which equals $70 × 3 = $210.

Step 3: Adjusting entry increases a liability, Salaries Payable, and increases Salaries Expense for $210 with the following journal entry:

Dec. 31	Salaries Expense	210	
	Salaries Payable		210
	To record three days' accrued salaries		

Learning Objective P3: Prepare adjusting entries for accrued expenses.

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Adjusting for Accrued Salaries – Financial Statements

(Balance Sheet)

SALARIES PAYABLE

	$210 12/31 adj.
	$210 12/31 Bal.

The Balance Sheet will show $210 of Salaries Payable owed.

(Income Statement)

SALARIES EXPENSE

$1,400	
12/31 adj. 210	
12/31 Bal. $1,610	

The Income Statement will show $1,610 total Salaries Expense.

Learning Objective P3: Prepare adjusting entries for accrued expenses.

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Future Cash Payment of Accrued Expenses

Accrued expenses at the end of one period result in a cash payment in a future period.

On 12/31, FastForward recorded accrued salaries of $210.

On 1/9 of the next year, the following entry will reduce the accrued liability, salaries payable, and record the expense for 7 days of work in January.

Jan 9	Salaries Payable (3 × $70)	210	
	Salaries Expense (7 × $70)	490	
	Cash		700
	To record earned revenue received in advance		

Learning Objective P3: Prepare adjusting entries for accrued expenses.

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Learning Objective P4

Prepare adjusting entries for accrued revenues.

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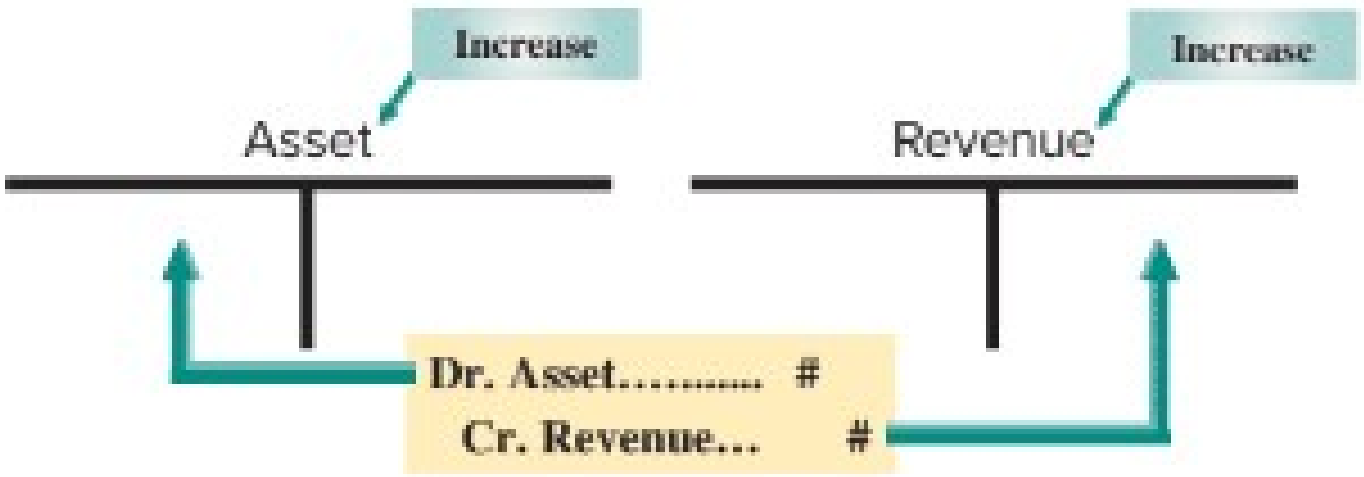
Accrued Revenue

Accrued revenues are revenues earned in a period that are both unrecorded and not yet received in cash or other assets.

Exhibit 3.11



Learning Objective P4: Prepare adjusting entries for accrued revenues.

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Adjusting for Accrued Services Revenue – Steps 1, 2, and 3

Step 1: On 12/12, FastForward's customer agreed to pay $2,700 on 1/10 of the next year for future services over the next 30 days.

Step 2: On 12/31, 20 days worth of services have been provided and earned which totals $1,800 ($2,700 × 20/30 days).

Step 3: Adjusting entry increases an asset, Accounts Receivable, and increases the Consulting Revenue account for $1,800 with the following journal entry:

Dec. 31	Accounts Receivable	1,800	
	Consulting Revenue		1,800
	To record 20 days' accrued revenue.		

Learning Objective P4: Prepare adjusting entries for accrued revenues.

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Adjusting for Accrued Services Revenue – Financial Statements

(Balance Sheet)

ACCOUNTS RECEIVABLE

adj. $1,800	
Bal. $1,800	

(Income Statement)

CONSULTING REVENUE

	$6,050
	1,800 adj.
	$7,850 Bal.

The Balance Sheet will show $1,800 of Accounts Receivable.

The Income Statement will show $7,850 total Consulting Revenue

Learning Objective P4: Prepare adjusting entries for accrued revenues.

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Future Cash Receipt of Accrued Revenues

Accrued revenue at the end of one period results in a cash receipt in a future period.

On 12/31, FastForward recorded accrued revenue earned of $1,800.

On 1/10 of the next year, the following entry will reduce the accounts receivable, record revenue earned for 10 days and receipt of $2,700 cash.

Jan. 10	Cash	2700	
	Accounts Receivable (20 days)		1800
	Consulting Revenue (10 days)		900
	To record earned revenue received in advance		

Learning Objective P4: Prepare adjusting entries for accrued revenues.

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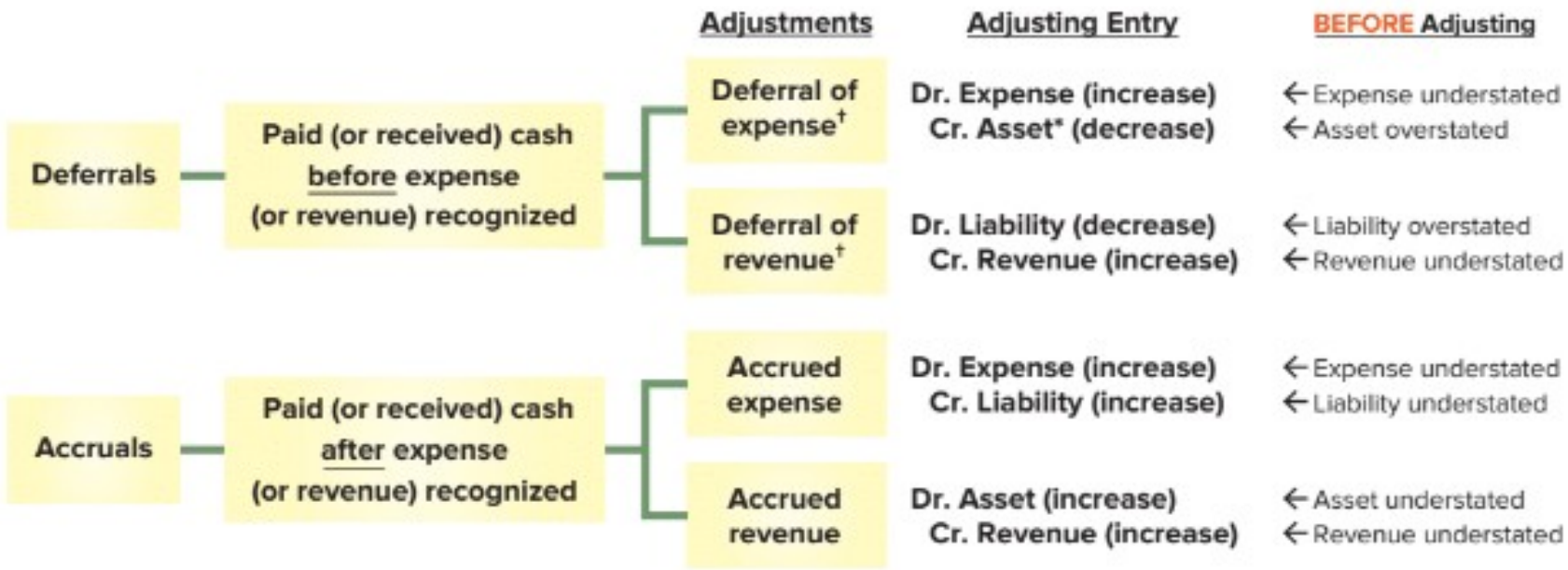
Links to Financial Statements

Exhibit 3.12



*For depreciation, the credit is to Accumulated Depreciation (contra asset).
†Exhibit assumes that deferred expenses are initially recorded as assets and that deferred revenues are initially recorded as liabilities.

Learning Objective P4: Prepare adjusting entries for accrued revenues.

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Learning Objective P5

Prepare financial statements from an adjusted trial balance.

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Adjusted Trial Balance

FASTFORWARD
Trial Balances
December 31, 2021

Acct. No.	Account Title	Unadjusted Trial Balance Dr.	Unadjusted Trial Balance Cr.	Adjustments Dr.	Adjustments Cr.	Adjusted Trial Balance Dr.	Adjusted Trial Balance Cr.
101	Cash	$ 4,275				$ 4,275	
106	Accounts receivable	0		(f) $1,800		1,800	
126	Supplies	9,720			(b) $1,050	8,670	
128	Prepaid insurance	2,400			(a) 100	2,300	
167	Equipment	26,000				26,000	
168	Accumulated depreciation—Equip.		$ 0		(c) 300		$ 300
201	Accounts payable		6,200				6,200
209	Salaries payable		0		(e) 210		210
236	Unearned consulting revenue		3,000	(d) 250			2,750
301	C. Taylor, Capital		30,000				30,000
302	C. Taylor, Withdrawals	200				200	
403	Consulting revenue		5,800		(d) 250		7,850
					(f) 1,800		
406	Rental revenue		300				300
612	Depreciation expense—Equip.	0		(c) 300		300	
622	Salaries expense	1,400		(e) 210		1,610	
637	Insurance expense	0		(a) 100		100	
640	Rent expense	1,000				1,000	
652	Supplies expense	0		(b) 1,050		1,050	
690	Utilities expense	305				305	
	Totals	$45,300	$45,300	$3,710	$3,710	$47,610	$47,610

Exhibit 3.13

Learning Objective P5: Prepare financial statements from an adjusted trial balance.

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Steps for Preparing Financial Statements from an Adjusted Trial Balance

Step 1— Prepare income statement using revenue and expense accounts from adjusted trial balance.

Step 2—Prepare statement of owner's equity using capital and withdrawals accounts from adjusted trial balance; and pull net income from step 1.

Step 3—Prepare balance sheet using asset and liability accounts from adjusted trial balance; and pull updated capital balance from step 2.

Step 4—Prepare statement of cash flows from changes in cash flows for the period (illustrated later in the book).

Learning Objective P5: Prepare financial statements from an adjusted trial balance.

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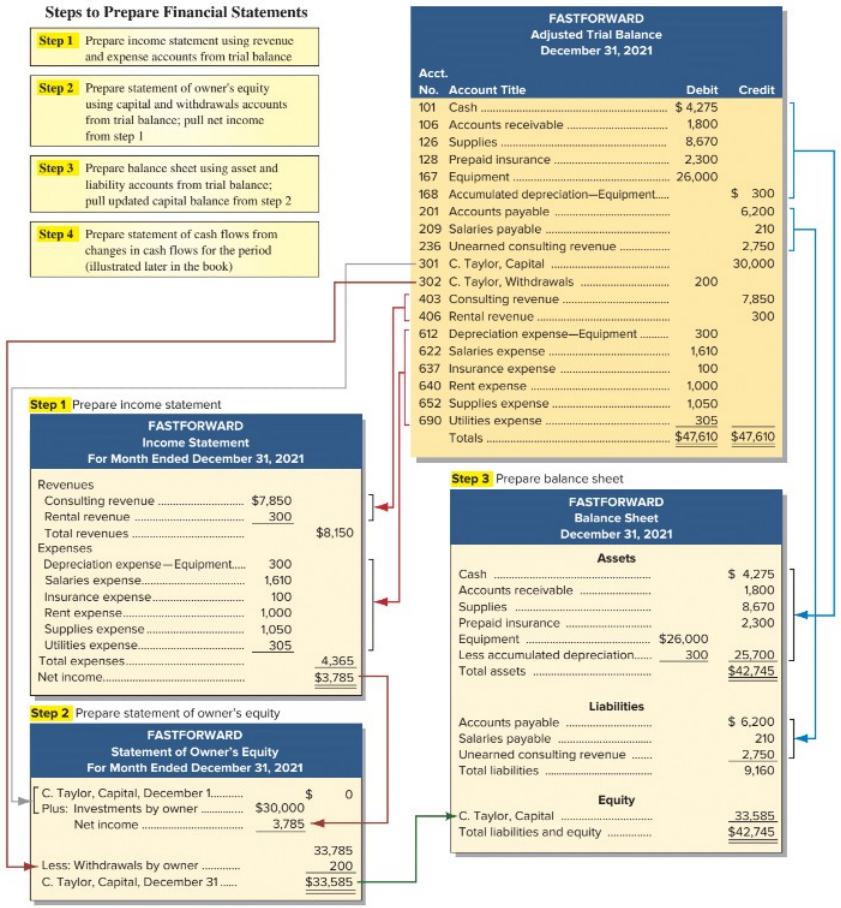
Preparing Financial Statements from an Adjusted Trial Balance

Exhibit 3.14


Steps to Prepare Financial Statements
Step 1 Prepare income statement using revenue and expense accounts from trial balance
Step 2 Prepare statement of owner's equity using capital and withdrawals accounts from trial balance; pull net income from step 1
Step 3 Prepare balance sheet using asset and liability accounts from trial balance; pull updated capital balance from step 2
Step 4 Prepare statement of cash flows from changes in cash flows for the period (illustrated later in the book)
FASTFORWARD
Adjusted Trial Balance
December 31, 2021
Acct. No. Account Title Debit Credit
101 Cash $ 4,275
106 Accounts receivable 1,800
126 Supplies 8,670
128 Prepaid insurance 2,300
167 Equipment 26,000
168 Accumulated depreciation—Equipment $ 300
201 Accounts payable 6,200
209 Salaries payable 210
236 Unearned consulting revenue 2,750
301 C. Taylor, Capital 30,000
302 C. Taylor, Withdrawals 200
403 Consulting revenue 7,850
406 Rental revenue 300
612 Depreciation expense—Equipment 300
622 Salaries expense 1,610
637 Insurance expense 100
640 Rent expense 1,000
652 Supplies expense 1,050
690 Utilities expense 305
Totals $47,610 $47,610
Step 1 Prepare income statement
FASTFORWARD
Income Statement
For Month Ended December 31, 2021
Revenues
Consulting revenue $7,850
Rental revenue 300
Total revenues $8,150
Expenses
Depreciation expense—Equipment 300
Salaries expense 1,610
Insurance expense 100
Rent expense 1,000
Supplies expense 1,050
Utilities expense 305
Total expenses 4,365
Net income $3,785
Step 2 Prepare statement of owner's equity
FASTFORWARD
Statement of Owner's Equity
For Month Ended December 31, 2021
C. Taylor, Capital, December 1 $ 0
Plus: Investments by owner $30,000
Net income 3,785
33,785
Less: Withdrawals by owner 200
C. Taylor, Capital, December 31 $33,585
Step 3 Prepare balance sheet
FASTFORWARD
Balance Sheet
December 31, 2021
Assets
Cash $ 4,275
Accounts receivable 1,800
Supplies 8,670
Prepaid insurance 2,300
Equipment $26,000
Less accumulated depreciation 300 25,700
Total assets $42,745
Liabilities
Accounts payable $ 6,200
Salaries payable 210
Unearned consulting revenue 2,750
Total liabilities 9,160
Equity
C. Taylor, Capital 33,585
Total liabilities and equity $42,745

Learning Objective P5: Prepare financial statements from an adjusted trial balance.

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Learning Objective A1

Compute and analyze profit margin.

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Profit Margin

The **profit margin** ratio measures the company's net income to net sales.

$$\text{Profit Margin} = \frac{\text{Net income}}{\text{Net sales}}$$

Exhibit 3.15

Visa and Mastercard's Profit Margin

Company	Figure ($ millions)	Current Year	1 Year Ago	2 Years Ago
Visa	Net income	$12,080	$10,301	$ 6,699
	Net sales	$22,977	$20,609	$18,358
	Profit margin	**53%**	**50%**	**36%**
Mastercard	Profit margin	48%	39%	31%

Exhibit 3.16

Learning Objective A1: Compute and analyze profit margin.

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Learning Objective P6

Appendix 3A
Explain the alternatives in accounting for prepaids.

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Alternative Accounting for Prepayments

An alternative method is to record all prepaid expenses with debits to expense accounts

Payment Recorded as Asset			
Dec. 1	Prepaid Insurance	2,400	
	Cash		2,400

Payment Recorded as Expense			
Dec. 1	Insurance Expense	2,400	
	Cash		2,400

The adjusting entry depends on how the original payment was recorded.

Payment Recorded as Asset			
Dec. 31	Insurance Expense	100	
	Prepaid Insurance		100

Payment Recorded as Expense			
Dec. 31	Prepaid Insurance	2,300	
	Insurance Expense ..		2,300

Exhibits 3A.1 & 3A.2

Learning Objective P6: Explain the alternatives in accounting for prepaids.

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Alternative Accounting for Prepayments – Account Balances

Exhibit 3A.3

Payment Recorded as Asset

Prepaid Insurance			128
Dec. 1	2,400	Dec. 31	100
Balance	2,300		

Insurance Expense			637
Dec. 31	100		

Payment Recorded as Expense

Prepaid Insurance			128
Dec. 31	2,300		

Insurance Expense			637
Dec. 1	2,400	Dec. 31	2,300
Balance	100		

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Alternative Accounting for Revenues

An alternative method is to record all revenues to a liability account or a revenue

Receipt Recorded as Liability				Receipt Recorded as Revenue			
Dec. 26	Cash	3,000		Dec. 26	Cash	3,000	
	Unearned Consulting Revenue		3,000		Consulting Revenue		3,000

The adjusting entry depends on how the original

Receipt Recorded as Liability				Receipt Recorded as Revenue			
Dec. 31	Unearned Consulting Revenue	250		Dec. 31	Consulting Revenue	2,750	
	Consulting Revenue		250		Unearned Consulting Revenue		2,750

Exhibits 3A.4 & 3A.5

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Alternative Accounting for Revenues – Account Balances

Exhibit 3A.6

Receipt Recorded as Liability

Unearned Consulting Revenue			236
Dec. 31	250	Dec. 26	3,000
		Balance	**2,750**

Consulting Revenue			403
		Dec. 31	**250**

Receipt Recorded as Revenue

Unearned Consulting Revenue			236
		Dec. 31	**2,750**

Consulting Revenue			403
Dec. 31	2,750	Dec. 26	3,000
		Balance	**250**

Learning Objective P6: Explain the alternatives in accounting for prepaids.

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End of Chapter 3

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